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UNCLAS SECTION 01 OF 03 MEXICO 000811

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SUBJECT: EVERY CRISIS IS AN OPPORTUNITY; MEXICO SEES POSITIVE
TRENDS IN PUBLIC FINANCE, AND OPPORTUNITIES FOR REFORM

11. (SBU) Summary: While the deepening global crisis has worsened Mexico's economic outlook for 2009, the Mexican government feels it has a cushion to weather the crisis and shield its public finances in 2009 and 2010. The Finance Secretariat's chief economist pointed to the successful oil hedging, the increase of its public deficit to 1.8% of GDP, loans from multilateral organizations, and about \$ 9.3 billion in the government's oil stabilization funds as positive elements. Nevertheless, the expected duration of the economic recession and the projected decline in oil production and prices will significantly reduce the government's tax collection and revenues. Over the next year, President Calderon's government will likely look closely at a broader tax reform, a gradual freeing of some government administered prices, and even cutting spending if required to prevent increasing the fiscal deficit. Despite a gloomy economic prognosis through 2011, our contacts see the crisis as an opportunity to pass much needed and overdue structural reforms to improve Mexico's competitiveness and stability. END SUMMARY

12. (SBU) We spoke last week with Miguel Messmacher (strictly protect), the chief economist at the Secretariat of Finance and Public Credit. A political appointee in his mid-30s with a Ph.d in economics from Harvard University, Messmacher has also done a stint at the IMF until 2007. He listed a number of items that would help cushion Mexico's public finances in 2009-2010.

OIL HEDGING SHIELD PUBLIC FINANCES IN 2009

13. (U) In 2008, when oil prices were plummeting from over \$120 per barrel to around \$90 per barrel, the Mexican government successfully locked in oil prices of at least \$70 per barrel, protecting its 2009 oil revenues and shielding its public finances. The cost of the oil hedging was \$1.5 billion, but the government expects to obtain revenues for about \$9.2 billion from it.

GETTING BETTER FINANCING FROM THE IDB AND WORLD BANK

14. (U) To support the government's countercyclical measures, in particular more public spending on infrastructure, the Congress, under the balanced budget requirement, authorized an increase in the fiscal deficit in 2009 from zero to 1.8% of GDP. It also lifted the government's indebtedness cap to allow the government to request loans from multilateral organizations. The government is in the last stage of negotiations for securing loans from the Inter-American Development Bank and the World Bank for 2009 and 2010, which offer attractive conditions for mid-income countries like Mexico.

15. (SBU) Miguel Messmacher said that the International Monetary Fund's Short-Term Liquidity Facility (STLF, announced in October 2008, was not entirely designed for countries like Mexico. The Mexican government along with other countries sent its comments to the IMF, which according to Messmacher, is in the process of designing a more suitable/simplified lending mechanism or "flexible credit line".

2009 CURRENT ACCOUNT DEFICIT FULLY-FINANCED

16. (U) Finance Secretary Agustin Carstens has been on record that lower remittances, exports, foreign direct investment and tourism inflows in 2009 will increase Mexico's current account deficit to around 2% of GDP. (Note: most analysts expect a current account deficit of between 2.4 and 2.6% of GDP. End Note). However, Carstens also asserts that the current account deficit will be fully financed by the expected year-end capital surplus thanks in part to the additional revenues

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from the oil hedging and the \$13.8-billion financing from multilateral organizations.

FINANCIAL CUSHION FOR 2009

17. (SBU) The peso depreciation, which on one hand has put pressure on core inflation, on the other has been beneficial to the government because with the peso conversion it gets more pesos for its oil exports. The peso depreciation will also generate revenues for the Bank of Mexico via its seigniorage. These revenues will be transferred to the Finance Secretariat. The government could also obtain additional recurring revenues from public bids on toll roads. (Note: the second public bid of a package of toll roads included in the FARAC, the government's bailout program, was abrogated as a result of the existing credit crunch. End Note). Moreover, the government has a cushion of about \$9.3 billion in its Oil, Pemex investment and Transfers to the States' Stabilization Funds.

BUT WHAT ABOUT 2010?

18. (SBU) The government seems to be at a crossroads on how to meet its 2010 and other medium-term goals. Key obstacles are declining oil production and depressed international prices, a public sector that relies 40% on oil revenues, the unlikelihood of hedging as effectively against its oil revenues, and lower non-oil tax collection given the economic slowdown. However, according to Messmacher, government officials have decided that to meet the challenge, they will have to make fiscal adjustments equivalent to 0.5% of GDP, for which they would have to do a number of things. These include cutting spending, gradually freeing government-administered prices to a level above the expected inflation, and approving some kind of tax reform.

PASSAGE OF A BROADER FISCAL REFORM?

19. (SBU) For the most part, the pressure on public finances as a result of the decline in oil revenues and the low tax

collection rates has led the government to think about passing a broader fiscal reform, which includes indirect taxes such as applying a VAT on food and medicines and the elimination of current loopholes. However, the Executive is aware that in the run up for the mid-term elections, it cannot introduce such a reform. It will likely wait until after the elections to try and pass a fiscal reform. If the government is unable to pass an ambitious tax reform, it will have to make use of its public prices (such as gasoline) to raise its revenues, but taking care not to create an inflationary bubble.

¶10. (SBU) While most analysts say the opposition PRI will likely win a plurality in the Congress during the July 2009 midterm elections, Hacienda officials say the PRI state governors will likely be the most supportive of an ambitious tax reform because they are unwilling to see a decline in their federal tax transfers. Messmacher said PRI leaders are also aware of the need for passing another tax reform to protect public finances in case they win the presidential elections in 2012. Therefore, they might think it is better to have Calderon's National Action Party assume the political cost now rather than having to deal with the problem in the future.

COMMENT

¶11. (SBU) The Mexican press has recently quoted Finance Secretary Agustin Carstens acknowledging that the effects of the global crisis will be felt in Mexico like an economic "tsunami", a quite different view from when he stated last year that the country would only catch a mild cold. This

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acknowledgement has led the government to think carefully about whether the announced measures will be sufficient to climb out of the hole or whether they need additional policy changes that look at the medium term. Due to the expected slow recovery of the U.S. and Mexican economies, the government is already planning the next steps for the medium term. The current crisis has highlighted the urgent need for passing broader tax reforms to become competitive again. To be effective, these reforms might also include telecommunications, labor, education, expansion of banking services and credit.

BASSETT